

**HEARING BEFORE THE U.S. HOUSE OF
REPRESENTATIVES**

COMMITTEE ON THE BUDGET



**July 9, 2003
10:00 a.m. 210 Cannon House Office Building
Washington, DC**

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Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear before you today to discuss five important questions involving waste, fraud, and abuse in Internal Revenue Service (IRS) programs. Government agencies must always spend taxpayers' dollars wisely. However, during times of extremely tight budgets, it becomes even more important that steps are taken to eliminate waste, fraud, and abuse.

1. Your current estimate of the magnitude (in dollars) of waste, fraud, and abuse within your agency's mandatory programs.

It is impossible to accurately estimate the magnitude of waste, fraud, and abuse in IRS programs, but there are a number of areas of concern. For example, statistics are frequently cited that the tax gap (i.e., the difference between the amount of tax owed and the amount of tax voluntarily paid) is \$280 billion. The IRS estimated between \$8.5 and \$9.9 billion of the \$31.3 billion in Earned Income Tax Credit (EIC) claims on Tax Year (TY) 1999 returns should not have been paid. Further, an estimated \$40 to \$70 billion in taxes are believed to be avoided by an estimated 1 to 2 million taxpayers using offshore bank accounts.

However, all of these figures are just estimates, some are outdated, and some can be misleading. For example, it is not always clear what constitutes waste, fraud, and abuse. With respect to the EIC, if divorced parents share custody of a child, and both claim the EIC because each believes he or she is entitled to receive it, is that waste, fraud, or abuse? The \$8.5 to \$9.9 billion range cited earlier is for noncompliance; the amount involving outright waste, fraud, or abuse is not known.

Nonetheless, there clearly is waste, fraud, and abuse in IRS programs. For example, during Calendar Year 2001, IRS Fraud Detection Centers, which are designed to detect fraudulent returns and prevent issuance of related false refunds, identified \$338.3 million in 38,846 fraudulent claims involving 3,447 schemes. In addition, the advent of electronic filing of income tax returns has provided a new mechanism for unscrupulous preparers to commit fraud. IRS Criminal Investigation determined that fraudulent electronic filings through December 16, 2002, had increased 720 percent since the end of 1999. As another example, the IRS Frivolous Return Unit is using a computer program my office developed to identify and stop reparations credit claims (i.e., false claims for a special tax credit to African-American taxpayers who may be descendents of slaves). In just a 2-day period in March 2002, the Frivolous Return Unit reported that it identified 19 such claims, most of which were for more than \$40,000. I will be discussing more specific instances of waste, fraud and abuse in my response to question 3.

2. The general nature of these problems and how long they have persisted.

The IRS has been experiencing many significant problems that include declining enforcement actions, the lack of a current baseline measure of reporting compliance, a growing balance of uncollected accounts receivable, delays in modernizing its computer systems, weaknesses in its financial management controls, increasingly complex tax laws, and IRS employees' concerns over the mandatory termination provision in section 1203(b) of the IRS Restructuring and Reform Act of 1998 (RRA 98). Despite experiencing these problems, in recent years the IRS has processed a steadily increasing number of tax returns and revenue. From 1987 to 2001, the number of returns filed increased by 22 percent, from 140 million to 171 million. In approximately the same time frame, the amount of revenue received by the IRS increased from \$935 billion to \$2.1 trillion.

Declining Enforcement Actions: The examination rate has dropped significantly in recent years to a level that appears to have already been detrimental to the system. Specifically, the percentage of individual tax returns selected for examination has dropped from 1.67 percent in Fiscal Year (FY) 1996 to .57 percent in FY 2002. Additionally, a survey conducted for the IRS Oversight Board identified an 11-point drop (from 87 percent in 1999 to 76 percent in 2001) in the percentage of Americans who believe it is *inappropriate* to cheat on their tax returns.

Enforcement actions against individuals and businesses that purposefully conceal tax liabilities or even refuse to submit tax returns have fallen dramatically, despite concerns that tax cheating remains at high levels. The following chart exhibits the fact that, since FY 1996, the level of IRS enforcement activities has significantly declined.

Enforcement Action	Overall Decline FY 1996 – FY 2002
Face-to-Face Audits	70%
Correspondence Audits	56%
Liens	34%
Levies	79%
Seizures	97%

The overall decline in enforcement actions has been primarily attributed to a long-term reduction in compliance staffing, the redirection of compliance resources to customer service functions during the filing season, a decline in direct examination time, and concerns over section 1203(b) of the RRA 98. Specifically, collection revenue officer staffing decreased from 5,537 in FY 1996 to 3,495 in FY 2002, while during the same time examination staffing decreased from 17,406 to 13,046. Further, the number of examination and collection staff years detailed to customer service increased from 165 in FY 1996 to 974 in

FY 2000, although it has since declined to 217 for FY 2002. Direct examination time decreased from 52 percent in FY 1996 to 41 percent in FY 2000, but has since rebounded to 51 percent in FY 2002. Finally, as a result of the mandatory termination provision in section 1203(b) of the RRA 98, some IRS employees have been reluctant to take enforcement actions. This has been a deterrent to fair enforcement of the tax laws.

Lack of a Current Baseline Measure of Reporting Compliance: The IRS has not conducted Taxpayer Compliance Measurement Program (TCMP) examinations since 1988. These examinations required an exhaustive review of the entire tax return for those taxpayers randomly selected. The results of the TCMP were used to improve the effectiveness of selecting for examination returns that would result in a change. Without the TCMP, the IRS has neither had a reliable method to measure voluntary compliance, nor been able to determine the effect that increased customer service and diversion of compliance resources are having on voluntary compliance.

Uncollected Accounts Receivable: The IRS is challenged by an increasing balance of accounts receivable (i.e., amounts owed to the IRS because of balance due, but unpaid, filings by taxpayers, and IRS enforcement actions). From FY 1996 to 2002, this balance increased from \$216 billion to \$280 billion. The IRS has estimated that approximately \$77 billion of the \$280 billion is potentially collectible.

Need for Modernized Computer Systems: The IRS' goal of providing efficient and responsive information services to its operating divisions is heavily dependent on modernizing its core computer systems while maintaining the existing systems. Since 2001, the Business Systems Modernization (BSM) Program has been deploying projects and learning valuable lessons that should help improve future projects. As of the end of FY 2002, the 8 BSM projects that are currently being developed and deployed had experienced cost increases of 26 percent and delays averaging 13 months over initial estimates, most occurring during the planning and design phases of these projects. The BSM Office forecasts that future project costs and schedules will be much closer to the estimates.

One of these projects, the Customer Account Data Engine or CADE, will eventually replace the existing Master File of taxpayer accounts. CADE will be the foundation for managing taxpayer accounts in the modernized IRS. CADE and related applications will improve customer service and compliance. Although the IRS and its contractor have made progress in delivering the CADE project, the Release 1 deployment date is now estimated to be August 2003, which is about 20 months behind its original planned delivery date. Since CADE is the foundation for other projects, its delay means that taxpayers are not receiving the benefits of faster processing, and other projects that will provide improved customer service and compliance activities will also be delayed.

Weaknesses in Financial Management Controls: Although the General Accounting Office (GAO) gave the IRS an unqualified (clean) opinion on its FY 2002 financial statements, GAO reported that the IRS' internal controls were not effective and its financial management systems lacked substantive compliance with the Federal Financial Management Improvement Act. Some control weaknesses affect the IRS' ability to properly manage unpaid assessments, resulting in both taxpayer burden and potentially billions of dollars in lost revenue. Other weaknesses in controls over tax refunds could result in the disbursement of billions of dollars of improper refunds. Also, weaknesses in computer security controls may allow unauthorized individuals to access, alter, or abuse proprietary programs and electronic data and taxpayer information.

Increasing Complexity of the Tax Laws: This further complicates the IRS' efforts to administer the tax system and minimize waste, fraud, and abuse. For several years, the Taxpayer Advocate has identified tax law complexity as a major concern. For example, according to the FY 2000 Taxpayer Advocate's Annual Report to Congress, tax law complexity was the highest-ranking problem individual and business taxpayers had with the IRS. In the 2002 report, the Taxpayer Advocate stated that the scope and complexity of the tax code make it virtually certain that taxpayers will face procedural, technical and bureaucratic obstacles in meeting their tax obligations. Small businesses are particularly affected by the complexity of tax law and IRS' related processes. For example, each year an estimated 46,000 small businesses are not successful in filing their U.S. Income Tax Return for an S Corporation (Form 1120S) because the IRS does not have valid elections on file to allow their returns to be processed. Consequently, these taxpayers spend an estimated 2.3 million hours each year preparing returns that cannot be successfully processed.

3. Illustrative examples of these problems.

On June 20, 2003, TIGTA provided a letter to the Chairman and this committee containing examples of audits and investigations that identified waste, fraud, and abuse involving the IRS in FYs 2002 and 2003. Our letter was in response to an effort initiated in May 2003 to scrutinize certain mandatory programs and identify examples of waste, fraud, and abuse sufficient to reduce outlays in those programs by 1 percent.

The following three sections provide brief synopses of (1) audit reports resulting in cost savings,¹ (2) significant audits/investigations that identified internal and

¹ Cost savings include funds put to better use and questioned costs. Funds put to better use are defined as funds that could be used more efficiently if management took actions to implement and complete a recommendation. Questioned costs are costs that are questioned because of an alleged violation of a provision of a law, regulation, contract, or other requirement governing the expenditure of funds; or a finding that, at the time of the audit, such cost was not supported by adequate documentation.

external fraud, and (3) audit reports that identified revenue protection² or trends in compliance and systems modernization. The first two sections were included in our June 20 letter; the third section, while not directly related to cost savings in appropriated funds, is nonetheless important since this audit work shows the importance of protecting tax revenue and other important trends. For each audit report, we have included a link to our web site to provide access to the entire report.

Reports That Identified Cost Savings at the Internal Revenue Service

Opportunities Exist to Expand the Telefile Program

<http://www.treas.gov/tigta/2003reports/200340092fr.pdf>

Opportunities exist for the IRS to expand its TeleFile Program to provide more taxpayers with the option of filing via telephone. The number of taxpayers who use the TeleFile system each year decreased from the 1998 to 2002 Filing Seasons. Since the expansion of the TeleFile Program in 1997, the IRS has not identified any additional opportunities to expand taxpayer TeleFile Program eligibility. The IRS' reluctance to expand the TeleFile Program is based primarily on management's incorrect perception that the processing costs for TeleFile tax returns significantly exceed the processing costs for paper filed and other electronically filed tax returns. Management also believes that the use of a telephone to file tax returns is considered obsolete because of the widespread use of computers and the Internet. To provide measurable benefits to both the taxpayer and the IRS, and to enable the IRS to continue to move towards its goal of having 80 percent of all tax returns *e-filed* by 2007, we recommended that IRS management develop a strategy outlining steps to be taken to offer the TeleFile Program to those taxpayers who file a Form 1040EZ and are currently ineligible to use the TeleFile system. We estimated that our audit would result in \$31.86 million in funds put to better use.

The Internal Revenue Service Continues to Owe Millions of Dollars in Interest to Taxpayers With Frozen Refunds

<http://www.treas.gov/tigta/2002reports/200230062fr.pdf>

The IRS was experiencing problems in releasing large dollar refunds because of the automatic freeze placed on accounts containing a credit balance of \$1 million or more. In a prior report, we indicated that controls did not ensure that frozen refunds were timely released and additional interest of approximately \$17.5 million was paid to taxpayers with frozen accounts. The IRS did not implement our recommendations as agreed, and our current review found that the IRS continues to pay millions of dollars in interest to taxpayers with frozen refunds. In

² Revenue protection involves the proper denial of claims for refund, including recommendations that prevent erroneous refunds or efforts to defraud the tax system.

51 percent of the frozen accounts we reviewed, the improperly frozen accounts resulted in issuing approximately \$185.8 million in refunds and paying taxpayers an additional \$15.4 million in interest. As a result of our recommendation, we identified \$12.9 million in funds put to better use.

Improved Oversight of the Guard Services Contract Is Needed to Ensure Compliance With Contract Terms and Conditions

<http://www.treas.gov/tigta/2003reports/200310076fr.pdf>

Increased oversight of the guard services contract is needed to ensure the contractor's compliance with all contract terms and conditions, particularly those concerning licensing. Although validations completed through October 2002 did not identify any issues related to the current employment of security guards with criminal convictions or immigration violations, the IRS paid \$4.7 million in costs during the time when the contractor was in violation of the contract, all of which we classified as questioned costs.

The Internal Revenue Service Could Reduce the Number of Unnecessary Notices Sent to Taxpayers Regarding Unreported Income From Schedules K-1

<http://www.treas.gov/tigta/2003reports/200330071fr.pdf>

In an effort to increase tax-reporting compliance and because of a mandate from the Senate Committee on Finance, the IRS began matching information reported to taxpayers on Schedules K-1 to the taxpayers' individual income tax returns. The IRS must ensure notices issued to taxpayers as a result of this matching are appropriate; otherwise, the IRS' compliance efforts will be compromised. Recently, the IRS suspended issuing notices resulting from underreported Schedule K-1 income and committed to evaluate the program to make enhancements. The IRS implemented several procedures to try and ensure notices were not issued to taxpayers unnecessarily. Despite these steps, the rate of assessments made on Underreporter Program cases related to Schedule K-1 income is significantly lower than the rate of assessments made for other Underreporter Program case income types. We recommended that the IRS make changes to the Form 1040 Schedule E to account for the original amount of Schedule K-1 income and to show offsets to this income. We further recommended that the IRS reevaluate the costs and benefits of key verifying data (entering data twice) or evaluate other ways to improve the accuracy of Schedule K-1 information in the IRS' database. Our audit identified \$3 million in funds put to better use that could be used to improve the accuracy of IRS processing of paper Schedules K-1.

Additional Cost Savings and Increased Productivity in the Print Operation and Computer Support Function Can Be Achieved at the Campus Locations

<http://www.treas.gov/tigta/2003reports/200320035fr.pdf>

IRS management has frequently evaluated and modified the organizational structure of its Information Systems Division to accomplish program objectives. However, management could further increase the electronic dissemination of internal reports and improve performance measures. IRS management should require users to discontinue printing reports that are currently available in both printed and electronic format, convert additional reports to electronic format, and establish a process for migrating identified efficient report distribution processes to all campuses. Performance measures should also be established to assess the efficiency of the print operation and computer support function. Finally, performance management reports for the print operation and computer support function should be created to ensure that results are compared against performance measure goals and actions are taken to improve operational efficiency. As a result of our recommendations, we identified \$2.24 million in funds put to better use.

The Management of Information Systems Maintenance Contracts Can Be Improved

<http://www.treas.gov/tigta/2002reports/200220100fr.pdf>

The IRS is unnecessarily paying for maintenance on some computer assets. Maintenance contracts costing an estimated \$451,400 per year cover 5,236 computer monitors, 108 printers, and 206 fax machines. We estimated 10 percent of these items would fail and require repairs each year. Canceling the maintenance contracts and allocating approximately \$57,500 for replacements would save approximately \$393,900 per year (\$1,141,500 over 3 years).³ In addition, cabinets and racks typically do not require periodic maintenance and, therefore, should not be included in maintenance contract coverage. Canceling these maintenance contracts would save approximately \$13,600 per year (\$39,400 over 3 years).³ In total, our recommendations resulted in \$1.18 million in funds put to better use.

Pricing Discrepancies on the Long Term Maintenance Computing Center Contract

<http://www.treas.gov/tigta/2002reports/200210008fr.pdf>

The contractually agreed-upon price for specific contract line items was incorrectly priced by the contractor and/or its subcontractor. Specifically, the IRS was billed monthly for the yearly costs of maintenance coverage for nine contract

³ This calculation was based on the estimated savings for one year and the current Federal Funds Rate of 1.75 percent.

line items. Additionally, the IRS paid for a higher priced software upgrade than that provided by the contractor. Approximately \$580,000 was associated with these billing discrepancies, all of which we classified as questioned costs.

Audits and Investigations That Identified Internal and External Fraud

Significant Efforts Have Been Made to Combat Abusive Trusts, But Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved

<http://www.treas.gov/tigta/2002reports/200230050fr.pdf>

Since 1997, the IRS has made significant efforts to combat abusive trusts. However, our review of abusive trust-related returns examined and closed during the first quarter of FY 2001 showed that the IRS may not be consistently asserting the accuracy-related penalty. There is a risk that not penalizing taxpayers involved with abusive trusts could result in further noncompliance. We recommended that IRS management develop new penalty tables to monitor the application of the accuracy-related penalty and develop a system to capture examination data. We estimate that this could result in \$138.2 million in increased tax revenue over a 2-year period.

Computer Programming Can Be Used to More Effectively Stop Refunds on Illegal Claims for Reparations Credits

<http://www.treas.gov/tigta/2002reports/200230071fr.pdf>

Since the early 1990s, thousands of false claims have been filed with the IRS for reparations credits. Promoters use a variety of techniques to market the promise of a special tax credit to African-American taxpayers, who may be descendents of slaves. Because the manual screening of tax returns by IRS employees is subject to human error and some employees may knowingly allow these illegal claims to be processed, some claims for reparations credits are processed and refunds sent to taxpayers. IRS computer controls that identify and stop reparations claims processing could be significantly improved by using a TIGTA-developed computer program. It is estimated that by using this program, IRS employees could identify 91 percent more of these returns than they could using the existing processes and stop an additional \$90.7 million in refunds (revenue protection) from claims for reparations credits over a 5-year period.

Management Advisory Report: Significantly More Individual Taxpayers Inappropriately Received Disabled Access Credits for Tax Year 2000 Than for 1999

<http://www.treas.gov/tigta/2002reports/200230048fr.pdf>

We reported that individual taxpayers were inappropriately receiving tax credits on their TY 1999 U.S. Individual Income Tax Returns (Form 1040). These

taxpayers received the Disabled Access Credit even though their tax returns indicated no business reasons for taking the credits. The number of taxpayers involved was limited but the issue was significant in that many of the taxpayers were elderly Americans who were possible victims of promoters recommending unwise investments in pay telephones and automated teller machines and promising bogus tax credits. From TYs 1999 to 2000, the number of tax returns for which this credit was inappropriately allowed had increased by 28 percent. The amount of credit allowed on these returns totaled over \$1.25 million.

Identity Theft Ring Nets \$7 Million In Fraudulent Tax Refunds

A criminal complaint charged 19 individuals with conspiracy to file false claims against the United States. The investigation began when bank officials notified the TIGTA that tax refund checks were deposited in a tax preparer's bank account. TIGTA agents subsequently arrested the tax preparer for the theft and negotiation of stolen IRS income tax refund checks. The tax preparer, with co-conspirators, engaged in the filing of numerous fraudulent income tax returns using stolen social security numbers, resulting in millions of dollars in IRS refunds. The tax preparer pled guilty to conspiracy to file false claims against the United States.

In April 2003, the eighteen co-conspirators were indicted by grand jury on twenty-nine counts including conspiracy to file false claims.

Two IRS Employees Destroy Records

Two IRS employees were indicted for their role in the attempted destruction of IRS records. A citizen contacted the IRS to advise that numerous tax returns and other confidential documents were strewn on a city street. TIGTA agents secured several trash bags filled with current tax returns and taxpayer correspondence that had been removed from an IRS processing center by one of the employees. The other employee placed the bags filled with the documents on the curb to be collected as trash. Both employees were terminated from employment and pled guilty to unauthorized disposal of government documents. The IRS reviewed over 300 taxpayer accounts and determined the total impact to the applicable taxpayers and the agency was approximately \$1.2 million.

IRS Employee Pled Guilty to Stealing Over \$191,000 in Remittances

An IRS Submission Processing Site employee altered the payee named on tax remittance checks and attempted to convert the money for personal use by depositing the checks into a personal bank account. The employee pled guilty and was sentenced to 5 years probation for stealing checks and a money order totaling \$191,871. TIGTA recovered the stolen money and the taxpayers' accounts were properly credited.

IRS Employee Arrested by TIGTA Special Agents for Solicitation of \$200,000 Bribe

An attorney representing a corporation reported that during a routine IRS examination, an IRS employee solicited a cash bribe of \$200,000 from the company's attorney to reduce the company's tax liability. In January 2002, with assistance from TIGTA, an electronically recorded meeting took place between the attorney and the employee. After receiving the \$200,000 bribe, the IRS employee provided the attorney with a fraudulent Revenue Agent Report. TIGTA special agents arrested the IRS employee before the employee left the meeting. The former IRS employee was sentenced to 24 months in prison followed by 3 years of supervised probation.

Former IRS Employee Pled Guilty to Misuse of IRS Computer System and Improper Relationships With Taxpayers

A former IRS revenue officer was charged with allegedly accepting gifts from different taxpayers, including approximately \$1,000 in cash, a television set, free health club privileges, free auto repairs, and free garage door repairs, for a payment plan of taxes and abatement of penalties owed by the taxpayers totaling \$158,741. The former employee was also charged with allegedly accessing an IRS computer without authorization and obtaining information from the IRS and with allegedly failing to deposit money of the United States under his control. The former IRS employee pled guilty and in March 2002, was sentenced to 4 months imprisonment and ordered to pay restitution of \$11,648.

Business Owner Indicted for Bribery

A business owner owed the IRS approximately \$410,829 in assessed taxes, penalties, and interest arising from an examination. The owner gave an IRS revenue officer checks totaling \$18,665 in return for delaying the collection of the owner's tax liability. In June 2002, the owner was charged with bribing an IRS employee.

Reports That Identified Revenue Protection or Trends in Compliance and Systems Modernization

Management Advisory Report: Improvements Are Needed to Assess the Use and Impact of the Earned Income Credit Appropriation **<http://www.treas.gov/tigta/2001reports/200140064fr.pdf>**

In 1997, the Congress provided the IRS with a special 5-year, \$716 million appropriation for the improved application of the EIC. The IRS does not adequately validate EIC results information, causing the inaccurate reporting of the use of the EIC appropriation funds to the Congress. Also, although

establishment of some compliance initiatives and a process to track the spending of funds have improved the application of the credit, the IRS has been unable to measure improvements in the EIC compliance for the approximately \$297 million spent on improving the application of the EIC. We recommended the IRS: establish a process to ensure the workload results reported in the *IRS Tracking Earned Income Tax Credit Appropriation* report to the Congress are complete, accurate, and reliable; and effectively measure the impact of the EIC initiatives on improving EIC compliance. Based on audit tests, we determined 1 function overstated the number of EIC cases by approximately 29 percent (1,015 cases) and a second function overstated the number of notices sent to taxpayers by approximately 23 percent (155,000 notices).

Better Controls Are Needed to Ensure Appropriated Funds Are Used to Improve the Application of the Earned Income Credit

<http://www.treas.gov/tigta/2002reports/200240020fr.pdf>

The Congress has been concerned with the IRS' ability to administer the EIC. The IRS established the EIC Program Office to administer the EIC appropriation and oversee the EIC-related activities of IRS functions involved in efforts to ensure the efficient application of the law; to increase participation of eligible taxpayers; and to reduce waste, fraud, and abuse. However, the IRS does not have an effective process in place to ensure that the expenditure of the EIC appropriation is only for EIC issues, programs, and projects. We recommended the IRS establish procedures to ensure that funds appropriated by the Congress for the improved application of the EIC are used for that purpose. These procedures should include providing guidance to the appropriate functions on using the EIC-related funds for expenditures, maintaining reliable data, and conducting periodic reviews of the expenditures to ensure they are being used for EIC-related items. Our analysis of the total labor expenses for 2 IRS functions and a judgmental sample of the IRS' equipment purchases for FY 2000 and the first quarter of FY 2001 identified approximately \$28 million in questionable expenses.

There Are Significant Weaknesses in the Internal Revenue Service's Efforts to Measure Earned Income Credit Compliance

<http://www.treas.gov/tigta/2002reports/200240021fr.pdf>

From TYs 1997 to 1999, the IRS made some improvements in its methodology to measure EIC compliance. However, that methodology still has some significant weaknesses. Specifically, some of the examinations in the TYs 1997 and 1999 EIC compliance studies lacked the necessary information to support the IRS' results, the IRS was inconsistent in its study methodology, the IRS' emphasis on EIC taxpayers with business income during the TY 1999 EIC compliance study increased the time spent on the examinations but has not produced any apparent benefits, and poor planning by the IRS has caused taxpayers to be needlessly examined as part of the TY 1998 EIC compliance study. We recommended the

IRS coordinate among functions to: ensure the quality review process occurs immediately after the examinations are completed (before they are closed), ensure IRS auditors are effectively trained on EIC issues and reminded of the importance of the studies, ensure the examination results from the EIC compliance studies are accurately credited or charged to taxpayer accounts, develop an acceptable methodology concerning where and how examinations are to be conducted on all future EIC compliance studies, develop a standardized sampling methodology that will measure EIC compliance rates at the lowest cost with the least amount of burden to the taxpayers, and capture and maintain detailed costing figures to monitor each study's return on investment. Based on our audit tests, we believe approximately 308 examinations used for compliance measurement are questionable.

Significant Tax Revenue May Be Lost Due to Inaccurate Reporting of Taxpayer Identification Numbers for Independent Contractors

<http://www.treas.gov/tigta/2001reports/200130132fr.pdf>

The IRS' ability to encourage the filing of accurate information returns for nonemployee compensation, through its administration of the existing back-up withholding and penalty provisions, is extremely limited and largely ineffective. Between TYs 1995 and 1998, the number of Miscellaneous Income documents (Forms 1099-MISC) reporting nonemployee compensation, received by the IRS with missing or incorrect Taxpayer Identification Numbers (TIN), increased by 36 percent. We recommended the IRS propose to the Department of the Treasury changes to several tax laws, explore opportunities to supplement its future Internet-based TIN confirmation program, and modify some administrative guidelines. Because the IRS was unable to match the documents with tax returns, we estimated that our audit would result in \$2.2 billion in income taxes collected per year through back-up withholding on nonemployee compensation payments to independent contractors that fail to furnish a TIN.

The Internal Revenue Service Has Made Some Progress, but Significant Improvements Are Still Needed to Reduce Errors in Manual Interest Calculations

<http://www.treas.gov/tigta/2002reports/200230042fr.pdf>

In 1993, the IRS Inspection Service (now the TIGTA) reported that 40 percent of the tax accounts it reviewed either contained errors in interest amounts computed by IRS employees or were unnecessarily restricted from automated computations. In 1994, in accordance with the Federal Managers' Financial Integrity Act, the IRS reported this issue as a material weakness in its internal control system. As a result, the IRS established a goal to reduce its high number of erroneous restricted interest assessments. While the IRS has achieved some success in increasing the automation of interest calculations, overall, its actions taken to address the material weakness in its controls over the calculation of restricted interest have not been effective. We recommended the IRS: limit the

calculation of restricted interest to centralized staffs within the various functions and locations of the IRS, establish a national quality review process that includes all restricted interest cases, establish training that must be completed before an employee can work restricted interest cases, authorize a standard interest computation tool that would be used by all employees working restricted interest cases, and explore all available options to provide the technology and programming necessary to allow more interest calculations to be performed by computer. We estimate that, over a 5-year period, the IRS could undercharge some taxpayers over \$145 million.

Trends in Compliance Activities Through Fiscal Year 2002

<http://www.treas.gov/tigta/2003reports/200330078fr.pdf>

The IRS' overall FY 2002 compliance efforts and results were mixed but showed some continuing positive changes that started in FY 2001. Specifically, the level of compliance activities and the results obtained in many Collection areas in FY 2002 showed a continuing increase, although some measurements decreased slightly in FY 2002 after increasing in FY 2001. Enforcement actions were higher or about the same in FY 2002 compared to the numbers in FY 2001. While enforcement revenue collected increased in FY 2002, the inventory of delinquent accounts and the total amount of uncollected liabilities have continued to grow. For example, from FY 1996 to FY 2002, enforcement revenue collected decreased from a yearly total of \$37.96 billion to \$34.09 billion, while gross accounts receivable increased from \$216 billion to \$280 billion. The number of examinations of tax returns increased in FY 2002, but the overall percentage of tax returns examined stayed about the same due to increases in the number of tax returns filed. The numbers and percentages of examinations of corporate and other business returns (except partnerships and very large corporations) continued to decrease or stay at about the same level. There were also slight increases in the numbers of examinations of fiduciary income, employment, and excise tax returns. We made no recommendations in this report.

Analysis of Business Systems Modernization Cost, Schedule, and Functionality Performance

<http://www.treas.gov/tigta/2003reports/200320007fr.pdf>

Beginning in 2001, the BSM Program delivered business results by deploying projects and learning valuable lessons that should help improve future projects. Deployed projects have increased the capacity of the IRS telephone system; improved the ability to receive, route, and respond to taxpayer telephone calls; and provided refund information via the Internet. However, as reported in previous TIGTA and GAO reports, the BSM Program has been experiencing difficulties meeting the original cost, schedule, and functionality estimates included in the BSM Spending Plans submitted to the Congress. Since the purpose of this review was to identify and analyze the cost, schedule, and

functionality performance compared to the original project estimates, we did not make any recommendations in this report.

4. What actions are being taken to eliminate or reduce these problems.

Given the volume of returns and revenue processed by the IRS, it would be a difficult task to fully eliminate all the problems that lead to waste, fraud, and abuse. However, the IRS has taken or plans actions to at least partially address some of the more significant problems I have described.

Compliance and Enforcement: In recent years, the IRS has reversed the trend toward devoting significant compliance resources to customer service. This action has helped to stabilize some compliance results, and customer service activities have received staffing increases to provide services.

For example, while the decline in many categories of enforcement actions and results since FY 1996 has been dramatic, there are recent indications that in some categories this trend has stabilized or even shown improvement. Overall, the IRS' FY 2002 compliance efforts and results were mixed, but showed some continuing positive changes that started in FY 2001. Specifically, the level of compliance activities and the results obtained in many, but not all, collection areas in FY 2002 showed an increase. In addition, for FY 2002, the number of criminal investigation cases initiated and in ending inventory was the highest since FY 1998. However, the number of cases referred to the Department of Justice and case convictions remained lower in FY 2002 than in FY 1998, yet higher than in FYs 2000 and 2001.

The IRS also increased the focus of its examination resources on six high-risk areas of non-compliance with the tax laws. These six strategic priority areas are: offshore credit card users; high-risk, high-income taxpayers; abusive schemes and promoter investigations; high-income non-filers; unreported income; and the National Research Program (NRP), which is discussed in more detail below.

National Research Program: To address the void created from the discontinuation of the TCMP, the IRS NRP Office was established in April 2000 as a component of the Research, Analysis, and Statistics Division. NRP is a comprehensive effort, using a statistically valid sample, to measure reporting, filing, and payment compliance for different types of taxes and various sets of taxpayers. The NRP will be used to update IRS' examination selection systems. After the IRS' workload selection formulas are updated with NRP data, the number of no-change examinations is expected to significantly decrease. As of February 14, 2003, a total of 33,738 NRP sample cases had been shipped to the field, which represented about 72 percent of the total 2002 NRP sample of 46,860. Of this total, related information has been assembled on 22,256 cases, and they are ready to be assigned to an examiner.

The NRP is scheduled to allow for the updating of the examination workload selection formulas by 2005. To accomplish this objective, examination of the NRP sample cases is scheduled to be completed by April 2004.

GAO issued a report in June 2002 on the IRS' NRP planning efforts. GAO concluded that the NRP design is likely to yield the type of information the IRS needs. In addition, GAO concluded that the NRP meets one of the IRS' key goals to minimize the burden that the NRP poses to taxpayers. GAO has assessed the IRS' efforts to gather trend data regarding the overall burden imposed by the 2002 NRP and will issue a report in this area soon.

TIGTA believes that the NRP is a much-needed first step for providing the information necessary to gauge compliance levels and direct IRS compliance resources towards areas where attention is most needed. TIGTA is currently conducting audit work to provide an early assessment of the implementation of the 2002 NRP at the field office level. To accomplish this objective, TIGTA is performing on-site interviews and analyzing actions to date on a sample of NRP cases at selected IRS field offices. TIGTA has met with the GAO NRP team several times to coordinate the audit approach to avoid overlap.

Planned Use of Collection Agencies: The IRS' proposal to contract out the collection of delinquent accounts to private collection companies has the potential to recover a significant amount of IRS accounts receivable. In 1996, the IRS piloted the use of collection agencies, and after a detailed internal evaluation, concluded that their use was not economically viable. The IRS' current approach, however, differs significantly from the prior methodology. Most importantly, in 1996 the collection companies were compensated with monies from the IRS' appropriated funds. In contrast, as part of its 2004 budget submission, the IRS has requested authority to fund the use of collection companies directly from the revenues collected by those companies.

The IRS plans to eventually place 2.6 million cases annually with collection companies. Treasury projects that this initiative will produce revenue of as much as \$1 billion through 2013. While this amount is significant, it represents a small portion of the \$280 billion in accounts receivable that were due at the end of FY 2002.

EIC Initiatives: IRS efforts to improve the administration of the EIC Program are ongoing. The IRS has implemented a number of initiatives targeting outreach, education, and compliance efforts. Also, it participated with Treasury in a task force to study EIC overclaims. This resulted in the IRS initiating significant changes to the way it will address EIC noncompliance, for example, by requiring some EIC applicants to provide additional information to the IRS to validate eligibility before payment (pre-certification).

The President's FY 2004 budget proposal includes an increase of \$105 million in EIC funding. This increase includes \$100 million to implement the pre-certification initiative. The IRS is also supposed to use compliance and other available data to determine whether specific groups of claimants can be eliminated from the pre-certification process because they pose less risk of claiming more EIC than that for which they are eligible. The Treasury's EIC taskforce estimated that the pre-certification process would potentially reduce EIC overclaims by \$2.3 billion.

In addition, the IRS recently reorganized the EIC Program Office to capitalize on the strategic planning and research resources in the Wage and Investment Division's Office of Strategy and Finance, and created an Executive Advisory Council made up of IRS executives involved in the administration of the EIC Program to help provide better oversight and coordination of the Program. The Program Office has also drafted new annual performance measures for the EIC Program for FYs 2003 and 2004.

Offshore Tax Shelters: In FY 2001, the IRS established the Offshore Credit Card Project. Underpinning the project are 2 "John Doe" summonses⁴ served on MasterCard International and Visa for the records of foreign bank accounts in more than 30 countries. This data, supplemented with merchant summons⁵ data, is to be used to develop cases for referral to the Compliance field function. TIGTA recently issued a draft report on its audit of the program, describing concerns with the IRS inconsistently using the accuracy-related penalty, potentially examining returns beyond the statute expiration date (which, except for special circumstances, would bar any tax assessments), and not having an adequate management information system to provide key information and trends for decision making.

In addition, in January 2003, the IRS initiated the Offshore Voluntary Compliance Initiative to help taxpayers become compliant if they are involved in abusive arrangements. The program ended in April 2003.

BSM Progress: During 2002, the IRS and its PRIME contractor identified and aggressively focused on improving 12 key processes to better ensure future success. Deployed projects have increased the capacity of the IRS' telephone system; improved the ability to receive, route, and respond to taxpayer telephone calls; and provided refund information via the Internet. There will be many challenges ahead, and the IRS and PRIME contractor need to effectively implement planned improvements in key management processes; commit the resources necessary to enable success; manage the increasing complexity and

⁴ A John Doe summons is any summons that does not identify the person with respect to whose liability the summons is issued. A John Doe summons can only be issued after the approval by a Federal court.

⁵ A merchant summons is a summons served on the merchants involved in transactions with the credit cards identified via the John Doe summons.

risks of the BSM Program; and maintain the continuity of strategic direction with experienced leadership.

Scheduled Corrective Actions for Financial Management Weaknesses: As shown in the attachment, the Department of the Treasury lists 9 internal control and financial management weaknesses at the IRS, including such things as the EIC, the growing inventory of accounts receivable, and the need for detailed transactions data to support custodial financial reporting of revenue. Some of these weaknesses have existed for many years, for example, property management and accounts receivable have both been listed since the 1980's.

Automated System for Tracking Tax Law Changes: In September 2002, TIGTA reported that the IRS had recognized the importance and sensitivity of tax law complexity, elevated the concerns to the highest levels within the IRS, and invested significant resources throughout the organization to address the problems. In addition, TIGTA concluded that the IRS' Legislative Implementation Tracking System will be an effective control to monitor the implementation of new tax legislation. The system is designed to provide timely, useful information to management and quickly elevate any delays in implementing new tax laws to a level of management high enough to address the problem.

5. What additional actions, of either an administrative or legislative nature, are required.

Addressing the issue of tax law complexity would require legislative actions. In fact, the National Taxpayer Advocate's FY 2001 Annual Report to Congress outlined proposals to simplify or clarify six areas of tax law – family status issues, joint and several liability, alternative minimum tax for individuals, penalty and interest issues, home-based service workers, and IRS collection procedures. Also in 2001, the staff of the Joint Committee on Taxation issued a comprehensive study of tax law complexity, which included numerous specific recommendations.

Legislation will have to be passed to authorize the Secretary of the Treasury to use private collection agencies and to allow the IRS to use a portion of taxes collected to fund the project. TIGTA has concerns whether IRS resources will be sufficient to provide adequate project management, contract oversight, and quality review; whether taxpayer rights and privacy will be adequately protected; and that the detailed design for the collection project has not been developed, including the system that will be responsible for selecting, controlling, and updating cases assigned to private collection companies.

Tax law changes are needed to effect significant improvement in information reporting and to protect the substantial tax revenues that are potentially being lost each year. The IRS agreed to consider the feasibility of proposing some new legislation to require mandatory withholding of income taxes on nonemployee

compensation payments, and changing the criteria for asserting the Incorrect Information Penalty. However, TIGTA is concerned that the IRS does not plan to enforce accurate TIN reporting once a TIN verification program is made available to payors. If the IRS does not require accurate TIN information from payors, compliance is not likely to improve.

Tax professionals and others expressed concerns about the difficulty in matching information from Schedules K-1 to individual income tax returns. The IRS must ensure notices issued to taxpayers as a result of this matching are appropriate; otherwise, the IRS' compliance efforts would be compromised. The IRS should carefully consider the benefits of the program, the cost of the program to the Federal Government and to taxpayers, and the enhancements that can be made to the program in the near term as a result of its own analyses, before proceeding with a program to match all data from Schedules K-1 again in 2003.

With regard to the BSM Program, we have recommended that the IRS issue more performance-based contracts to the PRIME contractor, tie incentives and disincentives to performance, and require the use of firm fixed-price task orders whenever possible and appropriate. We also recommended that the IRS reduce the number of BSM projects being developed in order to better control and manage the program, and to improve its management and governance capabilities and processes. Finally, we recommended that the IRS ensure that project development teams follow the established systems development life cycle methodology and processes to increase the likelihood of success. We will be issuing audit reports this year with additional recommendations to improve the effectiveness and results of the program.

The IRS needs to establish long-term goals and measures for the EIC Program that reflect the Program's anticipated outcomes over time, and establish a consistent method to measure progress toward these long-term goals. Only through consistent measurement will the IRS be able to demonstrate its progress over time and show how it has reduced erroneous payments or increased participation.

Finally, the IRS and other important stakeholders, such as the IRS Oversight Board, believe the agency needs more resources to accomplish its mission and goals. For FY 2004, the IRS requested funding of \$10.4 billion and 100,043 Full-Time Equivalents. This is an increase of \$521 million (5.3 percent) over the President's FY 2003 request. The largest portion of this increase will go towards strengthening compliance and customer service. The IRS emphasized that since

71 percent of its budget consists of salaries and benefits, any negative changes in the agency's financial situation could result in a negative impact on staffing levels. We believe that the IRS should consider expanding its workforce planning process from 3 to 5 years. This would increase the IRS' ability to identify risks and provide necessary data to key stakeholders.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to share significant problems and challenges that confront the new Commissioner and IRS senior management. TIGTA will continue its efforts to provide reliable and objective reviews and assessments of IRS programs and operations. It is our intent to not only identify waste, fraud, and abuse in IRS programs, but also to propose solutions to IRS management that address the underlying causes of the problems.